5-18-2017

The Case for Federal Preemption of State Blue Sky Laws

Rutheford B. Campbell Jr.
University of Kentucky, rcampbel@uky.edu

THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

The Case for Federal Preemption of State Blue Sky Laws

- *By Rutheford B. Campbell, Jr.* May 18, 2017

Society imposes legal requirements on businesses (issuers) when they offer or sell their securities to investors. These rules governing capital formation are generated both at the federal and state levels. State securities rules are generally referred to as "state blue sky laws."[1]

Both the federal rules and state blue sky laws contain antifraud provisions, which prohibit issuers that offer or sell their securities to investors from engaging in manipulative or deceptive acts. Federal and state rules also contain registration rules, which typically require issuers to provide closely prescribed investment information to designated state and federal governmental agencies (the Securities and Exchange Commission, for example) and to investors. Both state and federal securities rules provide a number of exemptions from their registration requirements. The exemptions are predicated on the issuer's meeting certain conditions.

In our market economy, imposing rules on capital formation makes economic sense. Well-constructed rules regarding capital formation can promote the efficient flow of capital to its highest and best use and prevent or ameliorate fraud or unfairness to investors. These rules, however, generate additional offering costs that may retard or in some cases completely choke off the flow of capital from investors to businesses.

The problem with state blue sky laws is their registration requirements, which significantly impede efficient capital formation and provide no material economic or societal benefits, such as protection of investors from fraud.

The pernicious effect of state registration rules is easily and vividly demonstrated. For example, a business that announces its offering by posting the offering information on its website or advertising its offer in a widely distributed publication would likely be subject to the separate and individual registration requirements of each of the 50 states. In each state, therefore, the issuer would be required either to file a registration statement with the state or qualify for one of the state's exemptions from its registration requirements.

It is impossible, however, to find any material benefit in such a regulatory system. If state registration authority were eliminated, investors would still be protected by federal registration provisions and by both state and federal antifraud requirements. Imposing on top of these protections 50 separate state registration regimes administered under each separate state's registration rules and by each separate state's securities administrators adds no material protection for investors. It does, however, significantly increase the issuer's offering costs to an extent that may make access to capital more difficult.

While state registration requirements in all cases amount to economic waste, they are especially debilitating for small businesses. This is the result of the structural and economic circumstances that small businesses face when they attempt to access external capital.

Small businesses usually seek relatively small amounts of external capital. One result of this is that financial intermediation – professional assistance from brokers and underwriters in finding and selling to investors – is likely unavailable. The yield from small offerings simply will not support the fees required for competent and honest financial intermediation. For example, in research I conducted, I found that only 5.8 percent of Regulation D offerings of $1 million or less reported having any financial intermediation.[2]

Related to this is the problem of relative offering costs. These are offering costs as a percentage of the size of the deal. It is relative — not absolute — offering costs that foreclose businesses from the capital markets. Offering expenses of $100,000 in an offering of $100,000 (relative offering expenses of 100 percent) will prevent the offering, while similar expenses in a $10 million offering (1 percent relative offering expenses) should not foreclose the business from the capital market.

Because small businesses typically seek small amounts of external capital, relative offering costs go through the roof when small businesses get saddled with multiple sets of registration rules imposed by state blue sky laws.

A harmful consequence of state blue sky registration requirements — a consequence readily demonstrable by empirical data — is the extent to which small issuers have abandoned the use of well-conceived, efficient federal exemptions from registration as a way to access external capital. Two federal exemptions designed for small businesses — Regulation A and Rule 504 — provide examples. Between 1995 and 2011, offerings under Regulation A essentially disappeared.[3] Also, offerings that could meet the requirements for Rule 504 were overwhelmingly moved to Rule 506[4] and limited to accredited investors[5], even though the requirements for Rule 506 were more onerous and expensive than Rule 504 and accredited investors may amount to only 5 percent of the population.

The abandonment of Regulation A and the migration away from Rule 504 were the results of issuers' unwillingness to underwrite the costs of meeting the multiple, separate and independent registration requirements of state blue sky laws.

Over the years, there have been efforts to ameliorate the burden imposed by state registration requirements on small businesses. So far, relief for small businesses has been very slow in coming an today is largely incomplete.

There are two reasons for this. First, state regulators have protected their regulatory turf vigorously and aggressively through an imaginative and largely effective defensive campaign.[6] Second, the Securities and Exchange Commission (Commission) has been unwilling to advocate in favor of federal preemption of state registration authority and, perhaps even more important, has been unwilling to exercise to any meaningful extent its clearly delegated authority to expand preemption by Commission regulations.[7]

The scant relief enjoyed by small businesses regarding capital formation, therefore, has been the direct result of statutes enacted by Congress that preempt state registration authority. The National Securities Markets Improvement Act (NSMIA) preempted state registration authority over Rule 506 offerings, and the Jump Start Our Business Startups Act (JOBS Act) preempted state registration authority over crowdfunding offerings and over some Regulation A offerings.

These preemptions, however, are of limited value to small businesses. Small offerings under Rule 506 are overwhelmingly limited to accredited investors, which may amount to only 5 percent of the population. Early data regarding crowdfunding and the new Regulation A offerings (generally referred to as Regulation A+) show what should have been apparent: The complexity and costs of meeting the requirements for those exemptions from federal registration make the exemptions unsuitable for the vast majority of the 5 million small businesses in this country.[8]

State authority over registration continues for all other offerings of securities by issuers. These include: (1) registered offerings by issuers of their securities that are not traded on a national exchange; (2) private placements under the common law of Section 4(a)(2); (3) offerings under Rule 504; (4) Tier 1 offerings under Regulation A+; (5) intrastate offerings under Rule 147; and (6) offerings to employees under Rule 701. These are vitally important options for small businesses to raise capital, and state registration rules amount to a significant and inefficient barrier to the use of these exemptions by small businesses.

Small businesses are critically important to our national economy. They provide, for example, employment for as much as 30 percent of our workforce. To survive and compete, these businesses must have an efficient access to external capital. That can be achieved only by the complete preemption of state authority over registration. History clearly shows that this preemption can only be achieved through a federal statute.

ENDNOTES

[1] In addition to states, our territories and the District of Columbia also have blue sky laws. *See* Louis Loss, Joel Seligman & Troy Paredes, 1 Securities Regulation 66 (5th ed. 2013) ("today all 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have blue sky laws in force.").

[2] Rutheford B Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919, 931, Tbl. IX (2011) (hereinafter "Campbell, *The Wreck of Regulation D"*).

[3] Rutheford B Campbell, Jr., *The New Regulation of Small Business Capital Formation: The Impact – If Any – of the JOBS Act*, 102 Ky. L.J. 815, 822, Tbl. II (2014) (hereinafter "Campbell, *The New Regulation of Small Business"*).

[4] *See* Campbell, *The Wreck of Regulation D*, *supra* note 2, at 928, Tbl. III.

[5] *See id.,* at 930, Tbl. VII.

[6] For a discussion of this, *see* Rutheford B Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act,* 66 Duke L. J. 605, 613-617 (2016).

[7] An exception is that the Commission did via regulation expand preemption over Tier 2 Regulation A offerings (offerings of up to $50 million). Unfortunately, this is essentially irrelevant for small businesses, since small businesses very rarely use Regulation A. *See* note 8, *infra*.

[8] For example, in the first eight months of its effectiveness, only an average of 26.3 of crowdfunding offerings per month were filed with the Commission. Data show even less use of Regulation A+ by small businesses. In the first 19 months following its effectiveness, on average only 2.8 Regulation A+ offerings per month of less than $5 million were filed with the Commission. These data were obtained from the subscription-only Lexis Securities Mosaic website.

This post comes to use from Rutheford B. Campbell, Jr., the Spears-Gilbert Professor of Law at the University of Kentucky College of Law. It is based on his recent article, "The Case for Federal Preemption of State Blue Sky Laws," available here*. The author thanks Cody Barnett and Andrew Donovan for their assistance in the preparation of this article.*